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Modern Evolution of the Chinese Bond Market

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Abstract

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Keywords

China, Bond Market, Economic Reforms

Disciplines

Chinese Studies | Finance and Financial Management | Portfolio and Security Analysis

Modern Evolution of the Chinese Bond Market

By

Chirag Manyapu

An Undergraduate Thesis submitted in partial fulfillment of the requirements for the

WHARTON RESEARCH SCHOLARS

Faculty Advisor:

Professor Frank Zhou, Accounting Department

THE WHARTON SCHOOL, UNIVERSITY OF PENNSYLVANIA

MAY 2018

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This paper examines the evolution of the Chinese bond market from its conception to present day with a primary emphasis on current reforms. China has had immense growth since it first implemented its liberalization policies in the 1970s, but in order to sustain this growth the country has to continually find new ways to develop capital. China's financial system is relatively obscure with not much data or public information out there and especially with regard to the country's relatively newer bond market. That being said there have been significant changes in China's economic policies in recent years as more and more foreign investors have been given access to the country's bond market. This paper breaks down all the major bond market reforms in China's modern history and provides the impact that these policies have had on the country's financial system.

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INTRODUCTION

China has had unparalleled growth in the past 50 years with the liberalization of its economic policies. The country is one of history's most renowned examples of what opening up an economy to the global marketplace does for growth. The country has undergone a significant shift from being a largely agrarian society to an industrial machine in the past few decades. Since its free-market reforms in 1979, China has had an average GDP growth of 9.5% through 2017, a pace described by the World Bank as "the fastest sustained expansion by a major economy in history" (Morrison 2018). The economic wealth China has generated to this point has been substantial, but the country requires an increasingly large amount of investment and capital to prevent an economic slowdown. Given China's recent economic reforms and the opening up of its bond market, foreign investors have a bigger incentive to understand how China's bond market works for their own investment and for the continual development of China. This paper will explore the evolution of China's bond market from its conception to the present day major reforms.

A massive country like China has such a large bond market and huge sums of debt and investments that it is definitely not out of the realm of possibility for China to default on its debt in the future. Since so much money is going in and out of China constantly, it is an important trend to watch out for. It is important to note China's risk-free rate on its government bonds over the years, to see how the market foresees the riskiness of the government's debt and to see the impact China's total debt has on the bond market. The country's goals of managing down its large debt stock as a proportion of GDP may prove difficult if debt growth and economic growth do not progress as desired. As with many emerging economies, there are many risks, and investors should be mindful of a potential reversal of recent looser capital controls if Chinese

authorities see the risk of foreign investor outflows as destabilizing. This is why China's recent economic policies in relation to its bond market are so crucial to examine when determining the future outlook of the country.

The Chinese bond market is relatively obscure with not much research, data, or activity, when compared to China's equity market. There is significantly less trades and most people are much more active in the Chinese stock market (Huang 2007). Because the bond market has a huge importance in China's further expansion, it is very interesting see why the bond market has not grown at the same pace as China's equity market. Especially being a massive emerging economy, a study examining the China bond market is extremely important. China's bond market is currently the third-largest in the world, with the yuan equivalent of \$9.4 trillion outstanding, yet has minimal foreign investment thanks to difficulty of access (Chong 2018). In the past decade, the tide has been changing as the Chinese government continues to create new economic policies to connect its country to the rest of the world. This paper will further examine these policies and question what this might mean in the future.

WHAT IS A BOND MARKET

The bond market, which is also called the debt or credit market, is the financial market where debt securities are issued and traded. The bond market consists of mostly government issued securities and corporate debt securities. Participants issue new debt in the market called the primary market and trade debt securities in the secondary market. Bond markets are very important because governments and corporations need to borrow money to fund their own capital investments. The creditworthiness of a government bond market, combined with its liquidity, can serve as a benchmark for risk-free rates and for pricing instruments in other markets. Such characteristics make government bonds a key store of value, especially during

times of market turmoil. Government bonds are generally regarded as safe investments unless the government is borrowing past its capacity and cannot repay its debt. Bond markets generally are not as volatile as the stock market and are mostly determined by interest rates. (Investopedia 2018)

HISTORY OF THE CHINESE BOND MARKET

Pre-2000s

The Chinese first used bonds as early as 1861, when they broke into the foreign bond market. They used foreign bonds frequently from 1861-1950 primarily so that their government could fund various wars. The Chinese government first issued their own bonds in 1950 with their Ministry of Finance, but issuance from the branch was terminated in 1958 under central government control. Only as a result of the great liberalization period of 1979 did the Chinese government resume issuing bonds again in 1981, primarily to address a shortfall in funding for national construction projects (Huang 2007). This was the start of China's grand opening to the world and the bond market provided significant capital during this process.

Initially China only had a primary market, where only new securities and bonds could be issued. Government bonds could not be traded until a secondary market was started in select cities in 1988 and the nationwide in 1990 when the Shanghai and Shenzhen stock exchanged opened up (Bai 2013).

From 1996, all tradable government bonds were issued through an auction system. A national unified bond custody and settlement system was established in December 1996 with the newly founded centralized securities depository, China Government Securities Depository Trust & Clearing Co., Ltd. Furthermore, the most powerful economic decision-making agency created

during the 90s was the State Economic Planning Commission, which allocates credit (often treated as grants for the state-owned enterprises (SOEs)) (Bai 2013).

China's secondary bond market includes three submarkets: the exchange market, the inter-bank market, and the over-the-counter (OTC) market. Until 1997, the exchange market was most active, and individual investors and commercial banks were the most active players. Banks were pulled out of the exchange market in 1997 and began conducting their trading in the inter-bank market. Since then, secondary trading for Chinese government bonds has been highly divided, with activity split among stock exchanges, the inter-bank market, and the OTC market. The OTC market has consistently accounted for only a small share of market activity (Bai 2013).

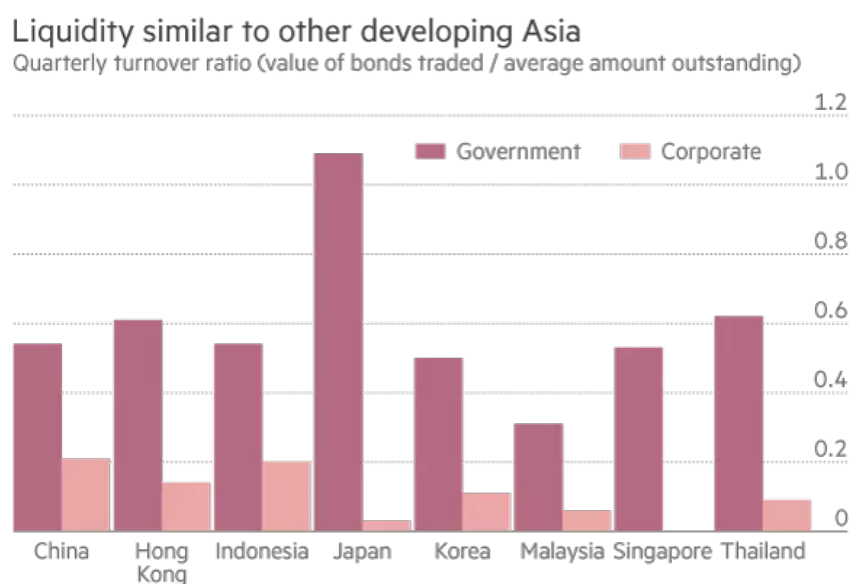
Present Day Market

The following are the six major types of instruments traded in the Chinese bond market:

- (i) Ministry of Finance (MOF)-issued China Government Bonds; (ii) People's Bank of China (PBC) paper; (iii) financial bonds issued by government-backed policy banks and financial institutions; (iv) corporate bonds issued by domestic corporations; and (v) commercial paper, issued by either securities firms or private corporations; and (vi) medium-term notes. Treasury bonds are debt instruments issued by the Ministry of Finance (MOF) to raise funds for large development projects and to cover budget deficits. Policy bank financial bonds are issued by the three policy banks as their primary source of funding. The three policy banks are the China Development Bank, Agricultural Development Bank of China, and Export-Import Bank of China. Corporate bonds are issued by state-owned enterprises (SOEs) or foreign joint venture enterprises to raise additional capital. New guidelines from the Chinese Security Regulatory Commission (CSRC) will allow corporations for the first time to issue bonds without bank guarantees, which could lead to private-sector domestic corporations issuing bonds. Commercial

paper are notes issued by corporations for short-term funding. Medium-Term Notes are issued by SOEs and other firms, subject to the approval of shelf registrations by the National Association of Financial Market Institutional Investors (NAFMII), a trade body established by the PBC (Asian Bonds Online 2018).

Overall liquidity in China's government and corporate bond market is comparable to that of other debt markets in developing Asia. But within these broad categories, the ease of trading varies greatly by bond type. Many bonds have low velocity, with banks and other investors holding them to maturity. Among sovereign bonds, policy bank bonds are often more liquid than treasuries. Among corporate bonds, medium-term notes approved by the People's Bank of China are more liquid than the enterprise bonds overseen by the National Development and Reform Commission, the state planning agency (Wildau 2018). The chart from the Asia Development Bank below shows China's liquidity is not that high when compared to other developing Asian countries. The Chinese bond market more commonly has short maturities, with a quarter



Source: Asia Development Bank

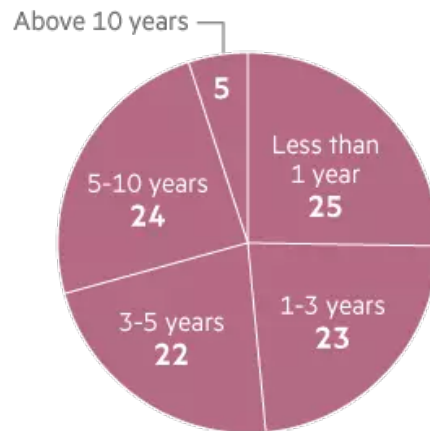
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currently due to mature in less than one year and 70 per cent in under five years. The chart below from Wind Info shows how only about 5% of China's bonds have maturities lasting longer than

ten years, where about 25% have maturities lasting less than one year. Nonetheless, even in

Market tilted towards short maturities

Remaining maturity of bonds outstanding (% of total)



Source: Wind Info

FT

stable times, China's yield curve is often flatter than that of other markets with the market turmoil in 2017 only making it worse. The yield curve is currently inverted, as tight liquidity has hit demand for medium tenors of around five years. The short supply of longer tenors, by contrast, means that demand has remained strong. China's market is infamous for failing to price risk correctly. Many investors presumptuously believe the government will bail out borrowers in danger of default, leading to a moral hazard; however, defaults have risen in recent years, weakening the notion of an implicit government guarantee for all debt payments (Wildau 2018). Based on Bloomberg data availability – “the data reveals that having a coupon, higher coupon rate, larger issue size, longer maturity, and more recent issuance are all associated with increased trading activity,” which can explain why China's bond market does not have as many trades as the equity market (Bai 2013).

The biggest four commercial banks own most of the Chinese bonds in order to decrease the risk of bank runs. The central bank of China forces its commercial banks to retain a certain amount of liquid assets because they are easy to sell and convert into cash. Government bonds can help commercial banks meet this demand of the central bank, as they are one of the most liquid instruments in the China's market. Especially with the country's undeveloped capital market, liquidity can be a big issue and government bonds help commercial banks solve it. Moreover, because government debts are more transparent than corporate debts, bonds issued by the government are supposedly less risky (Pham 2018). The chart from Wind info below shows how commercial banks own 22.81 trillion RMB in Chinese bonds.

Commercial banks dominate the market

Ownership by type (Rmb tn)



Sources: China Central Depository and Clearing; Shanghai Clearing House; Wind Info; FT estimates

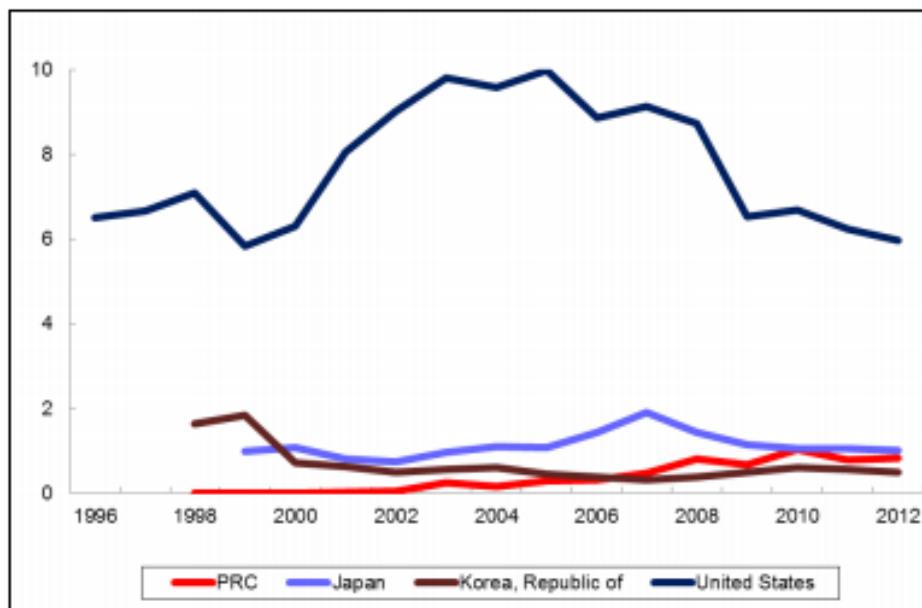
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The extreme dominance of the public sector in the domestic bond market—in terms of total outstanding amount and issuance—could facilitate renminbi internationalization in the short run. This is because public sector bonds are perceived to be less risky due to explicit or implicit

guarantees from the government. Public sector bonds are also less diverse due to having fewer issuers than corporate bonds. Given China's particularly weak bond market infrastructure, due to a lack of creditable rating agencies, public sector bonds are more attractive to foreign investors, and foreign central banks tend to hold such bonds as foreign exchange reserves. However, there is a limit for how many bonds the public sector can issue, and without corporate bonds, the development of the China's domestic bond market would be strained. A crucial way to increase the use of the renminbi internationally is to encourage the holding of renminbi-denominated assets by foreign investors and the broadening of China's corporate bond market is essential in creating these assets (Cruz 2014).

Despite its growth since 2000, the China bond market is not as active as in other developed economies. Bond market turnover in China is much lower than in the US as outlined by the graph from Asian Bonds Online. The lower level can be explained by the less diverse investor profile, as well as the control of commercial banks in the bond markets. China's

Figure 12: Bond Market Turnover Ratio



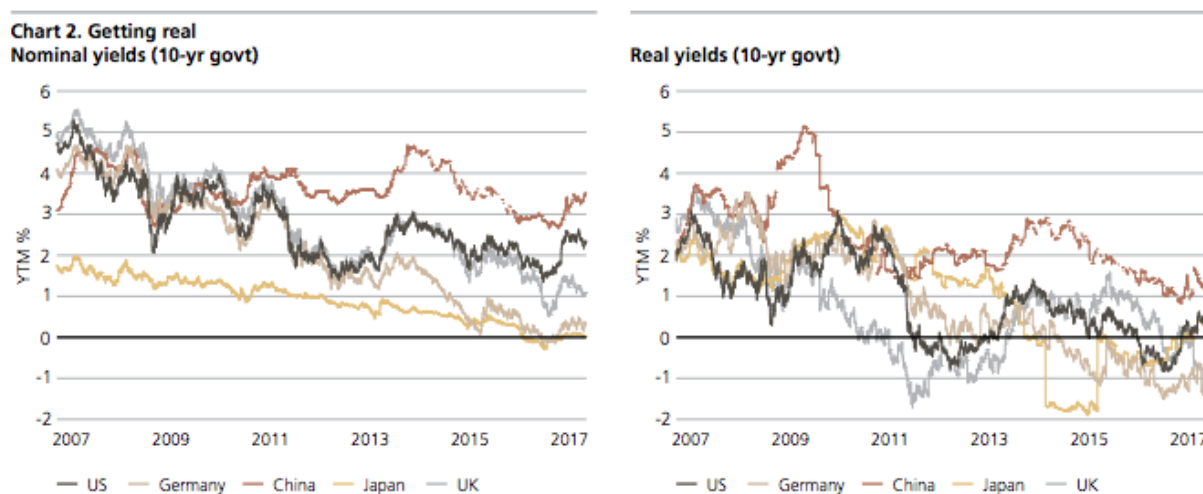
government bond turnover ratio, at 2.7 in 2012, was lower than that of the economies with international currencies, though on par or higher compared to other developing economies. The

turnover for US government bonds was the highest in 2012, which indicates its highly liquid market. The turnovers for other developed economies exceed outstanding volumes by more than 300%. Even so the turnover ratio for Chinese corporate bonds was higher than that of government bonds, as well as those in developed economies, including the US with its large and liquid corporate bond markets. Compared to government bonds, corporate bonds are more diverse in terms of maturity, coupon, default risk, and bond covenants due to each unique corporation. This diversity tends to lead to corporate bonds being held until maturity, leading to lower turnover ratios. Government bonds, on the other hand, have much more standardized instruments available, leading to easier trades (Cruz 2014).

Supplementing the domestic bond market, an offshore bond market has also risen as China has started to internationalize its currency. In 2003, offshore renminbi bonds appeared in Hong Kong, China with the formation of offshore settlement infrastructure and personal renminbi banking services. In June 2007, mainland China based financial institutions were officially allowed to issue renminbi bonds in Hong Kong, China. “With bonds offerings relatively small and with short maturities, these offshore renminbi bonds were commonly called ‘dim sum bonds.’ To distinguish them from the onshore bond market with a code of CNY (yuan), dim sum bonds were assigned the CNH code. The China Development Bank, the biggest of the China’s three policy banks, issued the first CNH bond worth CNY5 billion with a tenor of 2 years. For the first 4 years, the growth of the offshore bond market was relatively slow even after the Ministry of Finance entered the market in October 2009. From CNY10 billion in 2007, outstanding CNH bonds were only CNY30 billion in the second quarter of 2010” (Cruz 2014)”.

Debt Crisis

As a result of the global financial crisis, uncharacteristic monetary policy led to asset price inflation in all traditional asset classes. This in turn has created yield compression, with the amount of negative-yielding sovereign debt globally estimated at USD 8.6 trillion, according to Fitch Ratings (March 2017). By contrast, Chinese bonds offer attractive yields on both a nominal and real basis. As shown in Chart 2, yields on Chinese bonds compare favorably against global developed market bonds (UBS 2018).



An added benefit to income return, is also the potential for capital gains should bond yields move lower from their current levels. Even the Chinese government sees the value of stable financial markets, they have taken a structured and progressive liberalization approach to open its bond markets to foreign participation as one of the defining features of its financial reform plan. With the increasing liberalization of financial markets, there is a more efficient allocation of capital as private enterprises compete for funding, thereby offering savers a greater choice of investment options.

Concurrently, the Chinese government wants to lower systemic risk in the banking sector. It has been a far too common practice for local provinces and cities, via local government financing vehicles (LGFVs), to borrow heavily from banks to finance infrastructure projects and

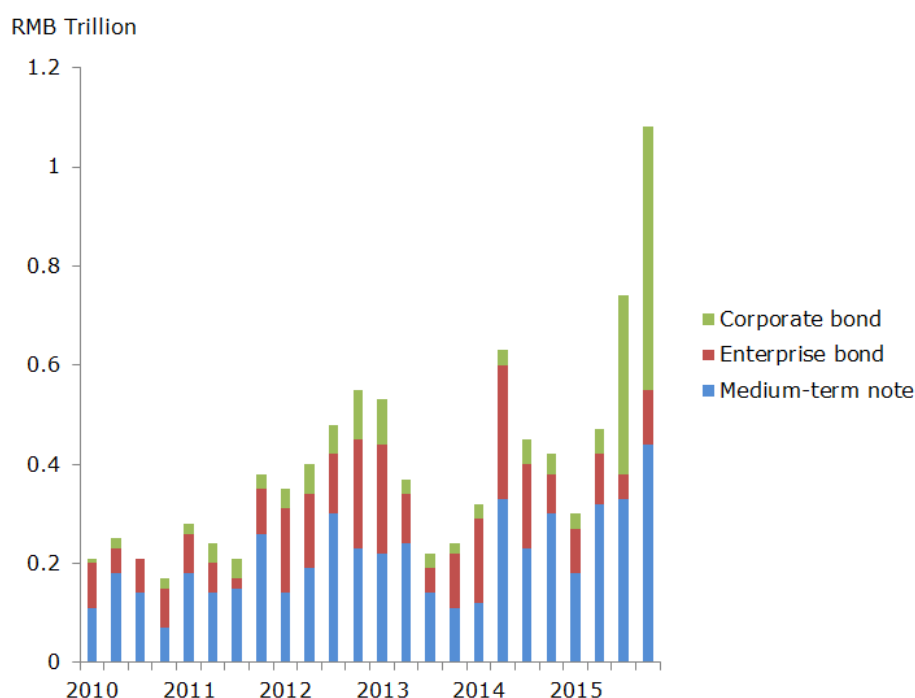
keep economic growth rising. This enormous increase in local debt and non-performing loans from unprofitable infrastructure projects has distressed China's regulators. As a result, in 2015, a new budgetary law was passed outlawing local provinces and cities from borrowing from banks, but instead required them to use publicly traded bond markets. In the US, the debt market consists of 30% bank loans and 70% publicly traded bonds, whereas in China only 12% of debt issued is in the form of bonds, with the remaining 88% comprising bank loans. This huge discrepancy is what has caused China to create policies that transfer the risk from banks to the public bond market. By adhering to international standards through reforms to its financial markets, this also allows an increase in foreign investors' participation in China's onshore bond markets (UBS 2018).

The debt issued by the local provinces and cities in China are broadly similar to the municipal bonds or local government bonds issued in other bond markets globally. In the US, the municipal debt market is worth an estimated USD 3.8 trillion. UBS investment bank expects "that China's local government bond market will grow to more than USD 3 trillion in the next three years, rising from its current level of USD 1 trillion...making it comparable in size to the US market with funding in both renminbi and US dollar terms" (UBS 2018).

CHANGING POLICIES

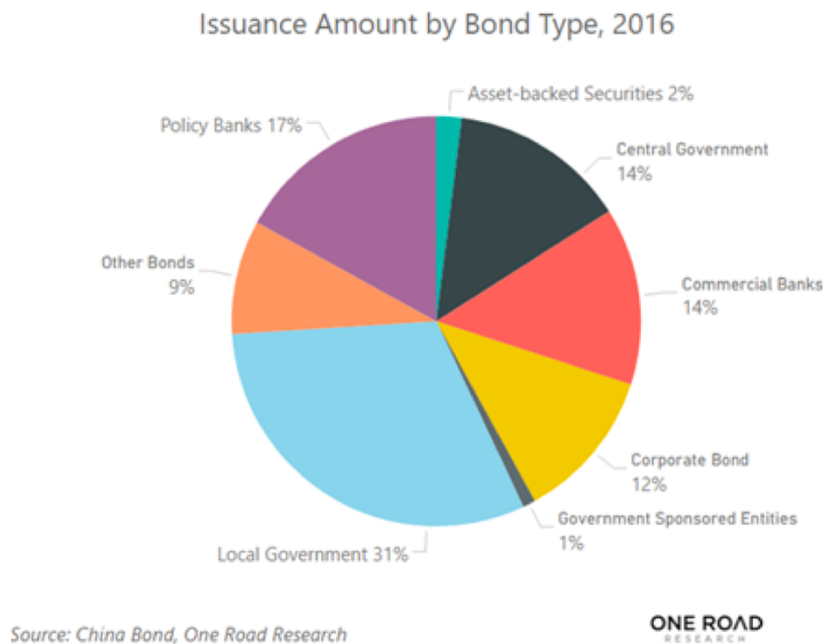
China's bond market has grown 8x over the past decade and is now worth approximately 9.4 trillion USD. It is the 3rd largest bond market after the U.S. and Japan. The government has created policies to facilitate this growth including one in May 2014, in which the State Council of China issued the *Guiding Principles for the Healthy Development of Capital Markets*. This was a policy document which called for increasing the share of direct financing in the economy and easing restrictions on bond issuance. As per the document, the government will increase the

proportion of financing via bonds and equity issuances, as opposed to bank lending. Second, corporations have been influenced to use the bond market for raising money as funding costs instead of the banks. As shown in graph below, issuance of corporate bonds and medium-term notes have grown dramatically over the past year.



This massive increase of government bond issuances were so local governments can replace their bank loans into bonds to restructure local debts. China has a state-controlled economy so most bonds are issued by entities linked to the government. In 2016, corporations may have issued RMB 15 trillion worth of bonds (around US\$2.2 trillion). But the Chinese government - including policy banks, the central government and local governments - have issued over RMB 35 trillion (around US\$5.3 trillion) worth of bonds. This number doesn't include the RMB 16 plus trillion (about US\$2.4 trillion) worth of debt, much of which is from state-owned enterprises (SOEs) (Borst 2016). This means buying Chinese bonds means you are most likely holding government debt, which means financing government development projects. In developing Asian economies, and especially in China these bonds finance the economic

growth of the country. The chart below from *China Bond* breaks down the bond issuance percentage for each type of bond and indicates how government bonds dominated the market (Borst 2016).



Interbank Market

The inter-bank bond market is administered by the National Inter-bank Funding Center and the Central T-bond Registration and Settlement Co., Ltd. and “provides a market for the bond transactions and repurchases of commercial banks, rural credit cooperatives, insurance companies, securities firms and other financial institutions. Most book-entry T-bonds, policy financial bonds are listed and traded in this market” (Huang 2007). By the end of 2005, there was over 5000 billion CNY yuan worth of bonds deposited at the inter-bond market, over 400 of which were in active trading.

Between 1998 and 2001, the government implemented a few of policy changes authorizing inter-bank market participation for insurance companies, agricultural credit institutions, fund management companies, securities firms, finance companies, and leasing

companies. A market maker system was established in April 2001 to increase liquidity in the market. Since then, investors have been allowed to participate in multiple markets. Since 2005, all book-entry government bonds have been issued simultaneously in either two markets (stock exchanges and the interbank market) or all three (Jingu (2008)).

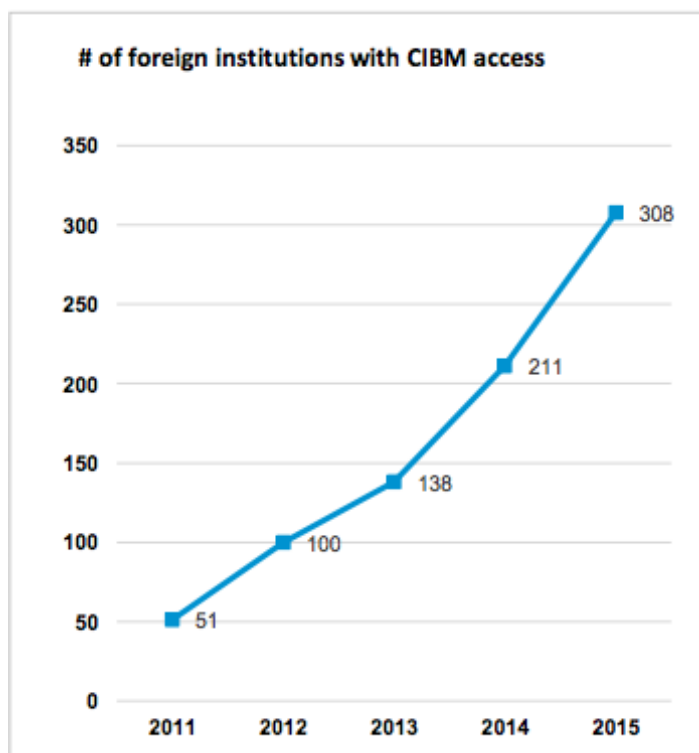
Increasing Openness

Over the years, China has progressively opened its bond market using quotas starting with the qualified foreign institutional investor (QFII) scheme, progressing to renminbi-Qualified Foreign Institutional Investor (RQFII). Starting in 2002, China opened a quota scheme that granted 279 investors a total of 80 billion USD investments, but the new RQFII scheme in 2011 gave more access to foreign institutional investors and allowed for larger investments to take place (BNP Paribas 2016).

China has a goal to have the renminbi included in the International Monetary Fund's Special Drawing Rights basket, but for this to happen there has to be greater access to China's markets. As a result in July of 2015, foreign central banks and sovereign wealth funds were given access to the interbank market. In April 2016, the rules were updated to remove restrictions on investment size and repatriation of funds. This was all done so China could meet the IMF'S goal to have a currency that is "freely usable" so that public institutions have sufficient access to onshore markets to undertake IMF transactions (Borst 2016).

CIBM Scheme

The CIBM Direct scheme was also introduced by the People's Bank of China (PBOC) in February 2016. This scheme reduced the rules to allow a wider range of financial institutions including banks, securities houses, investment companies and other long-term investors, to gain access to the onshore bond market without limits on repatriation. A wide range of foreign institutional investors would now be given quota-free access to the China Interbank Bond Market. This marks a dramatic shift in the process of opening China's capital markets, making it much easier for international investors to access the world's third-largest bond market and paving the way for further openings of cross-border investment in mainland securities. The graph below indicates how an increasingly larger audience has continually given more access to the Chinese bond market to reach 308 in 2015 through the CIBM direct access policy. Furthermore,



in late 2016, China opened up its domestic market to foreign investors for foreign-exchange and interest rate hedging purposes, and the elimination of foreign-exchange hedging restrictions is expected to take effect in 2017. As a result, in 2016, foreign-investor holdings in China jumped

by CN¥ 210 billion, or roughly \$30 billion (83% of which went into Chinese treasury bonds), which is more than a five-fold increase compared with 2015. Considering the overall low exposure of foreign investors to Chinese bonds relative to other emerging markets, market projections are for this to continue (Kornchankul 2018).

Bond Connect

Transitioning from a controlled direct economy to an increasingly free market economy, China's financial sector had its biggest policy change this past summer. Just recently on July 3rd, 2017 China opened up its bond market to foreign buyers for the first time. Fund managers are now allowed to buy local debt in mainland China via the Hong Kong Bond Connect. This is a huge reform from how China's bond market operated before and has major implications on the future growth opportunities China has. An influx of overseas money would not only help diversify funding for an economy loaded down with debt, but potentially spur market reforms such as improved corporate governance. Opening the debt markets will assist in the internationalization of the yuan, helping it climb the ranks of global reserve currencies. For that to happen, policy makers will need to free up the capital account so global investors know they can get their money out, not just in.

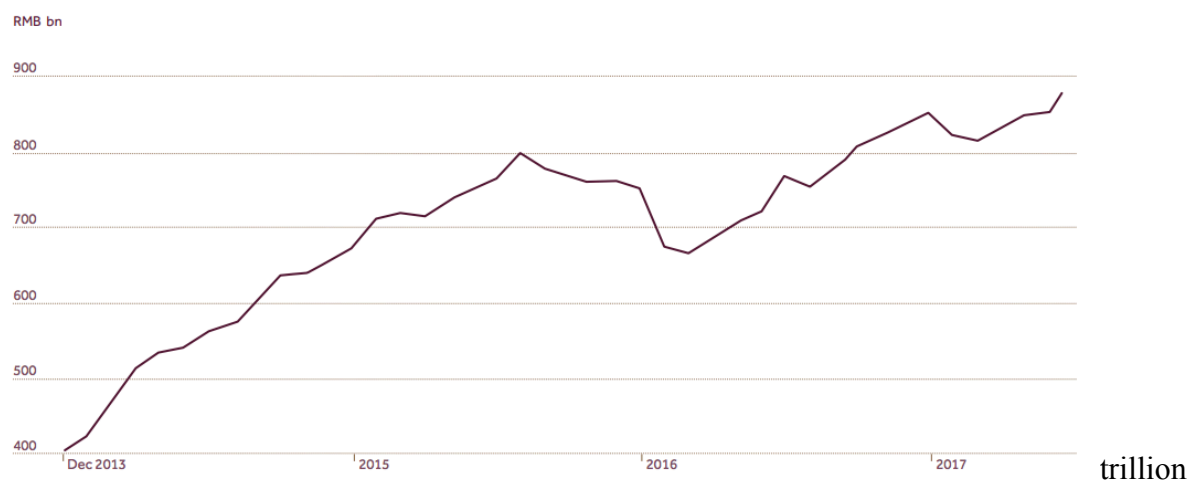
Bond Connect is expected to be the best way for foreign investors to get integrated with the onshore market. There is no quota requirement or need for investors to identify the intended investment amount, making it China's most accessible program to date. The link also uses the global infrastructure that is familiar to foreign investors. Tradeweb Markets is the first offshore trading platform announced for the scheme, with others set to join. Meanwhile, investors can select a global provider to hold assets in custody via a Hong Kong nominee account. Investors will also be able to use electronic requests for quotation. At the same time, the trading calendar

and hours of operation will be the same as those of the CIBM, giving investors the opportunity to become familiar with the Chinese market while having the comfort of an international infrastructure (BNP Paribas).

The Bond Connect program has seen increased activity from August onwards after a slow start, with trading by offshore investors in short-term debt spiking sharply. The total settlement value of Bond Connect transactions received by the Shanghai Clearing House nearly quadrupled in the week of August 21 to 11.8 billion RMB (\$1.8 billion) from the week before, data showed. Issuances are also increasing again, despite the government's anti-leverage campaign. Chinese companies sold 723 billion RMB of onshore notes in July, the most since November, according to Bloomberg data. And overseas investors increased their China onshore bond holdings by 62 billion RMB (\$9.3 billion) in the second quarter after a reduction of 22 billion RMB in the first three months of this year, according to central bank data (FTSE Russell 2017).

In June, foreign ownership of China's bonds reached a record high, as illustrated in the graph below. Some estimates project foreign holdings of onshore bonds may exceed 1

Foreign Investors Buy More China Bonds in June



RMB in the third quarter. "After the launch of Bond Connect, it's likely the capital inflow from international investors will drive up the onshore China bond market, creating a virtuous cycle

where capital attracts more capital,” says Michael Chow, Managing Director, Head of International Business, Fullgoal Asset Management (FTSE Russell 2017). Chow goes on to say how, “historically, it is more convenient for international investors to invest in the offshore China bond market. But in recent years China has strengthened the regulation and supervision of financial markets and institutions. As a result, the onshore bond market has experienced a large correction since November last year. Of course, there are still some necessary policies yet to be launched, and we might see more volatility in the China bond market in the near term.” Higher bond yields have continued to draw in more international market players with the yield on China’s 10-year government bonds reaching 3.62 percent in August (FTSE Russell 2017).

Bond Indices

While demand among international market participants for onshore bonds is picking up, index providers are considering including Chinese bonds in their emerging markets indexes. Earlier this year, Citigroup became the first fixed income index provider to include Chinese onshore bonds in its Emerging Markets Government Bond Index, Asian Government Bond Index and Asia Pacific Government Bond Index, with China’s weight in all three to be gradually increased over a three-month period from March next year (FTSE Russell 2017).

Teresa Kong, who is a portfolio manager at Matthews Asia contends that foreign access is an important barrier to China becoming part of the main bond indices. “Today, most investors can ignore China’s onshore bond markets and not participate at all, but when it becomes part of the major bond indices, it can no longer be ignored” says Kong (Chong 2017). If Chinese bonds are included in global indices, capital inflows of up to \$150bn a year can be expected, according to fund manager estimates. Five-year Chinese government bond rates are at about 3.5%,

compared with about 2% for US Treasury bonds and the barely positive yield on European bonds (Chong 2017).

Bloomberg LP is also planning on including China into its benchmark Bloomberg Barclays Global Aggregate Bond index. Bloomberg will phase the bond market over a span of 20 months, starting from April 2019. Only bonds from Chinese policy banks and yuan-denominated government paper will come into their benchmark index. Their share would represent around 5.5% of the total index, or around \$3 trillion, based on data from January 2018. “China’s new position in international bond portfolios will pave the way for robust market activity and support continued financial reforms,” said Henry M. Paulson, former U.S. Treasury Secretary and now co-chair of The Working Group on U.S. RMB Trading and Clearing, in a statement. Bloomberg will be the first to include debt from China into a major global benchmark index. Investors believe China’s inclusion in popular bond-market indexes is because regulators want to stagger access to its domestic financial markets. The being said, investors have shown continued interest in China’s bond market, because yuan-denominated bonds have higher yields than equivalently rated government bonds in developed markets like Europe. “Chinese government bonds offer some of the best value on the market right now and have seen a substantial yield lift through 2017,” wrote Hayden Briscoe, head of Asia Pacific Fixed Income at UBS Asset Management (Oh 2018).

RISKS

Currency

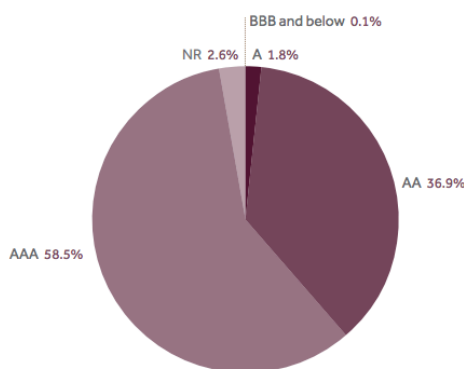
Finally, an important risk to consider when examining the Chinese bond market is any sudden change in government policy on capital controls. Even though recently China has taken shown a strong commitment toward the liberalization of its financial systems, there were some

decisions in the past that signaled China's willingness to control outflows to support its currency. Despite new policies to increase market access, expectations of currency weakness have been a factor limiting foreigners' holdings of onshore RMB bonds (Deutsche Bank 2016).

Credit Ratings

Foreign investors also regard Chinese local credit-rating agencies with suspicion because they virtually never give ratings below AA minus. Chinese agencies reply that riskier companies know they cannot access the market and therefore don't seek ratings at all. Another consideration is the quality of information available about Chinese credit. One issue that might puzzle some investors is the standards and methodology employed by domestic ratings agencies: some 51% of outstanding bonds in China are given AAA ratings locally. By contrast, in April 2016, following the downgrade of ExxonMobil by Standard & Poor's, just two US companies were left with AAA status. In some cases, the same Chinese company has been rated investment grade on the mainland by a domestic agency and junk offshore by an international one (BNP Paribas 2016). The vast majority of onshore bonds are still highly rated, especially corporate bonds – as illustrated in the graph below where 95.4% of bonds are rated AA or above.

Onshore corporate bond market credit ratings breakdown

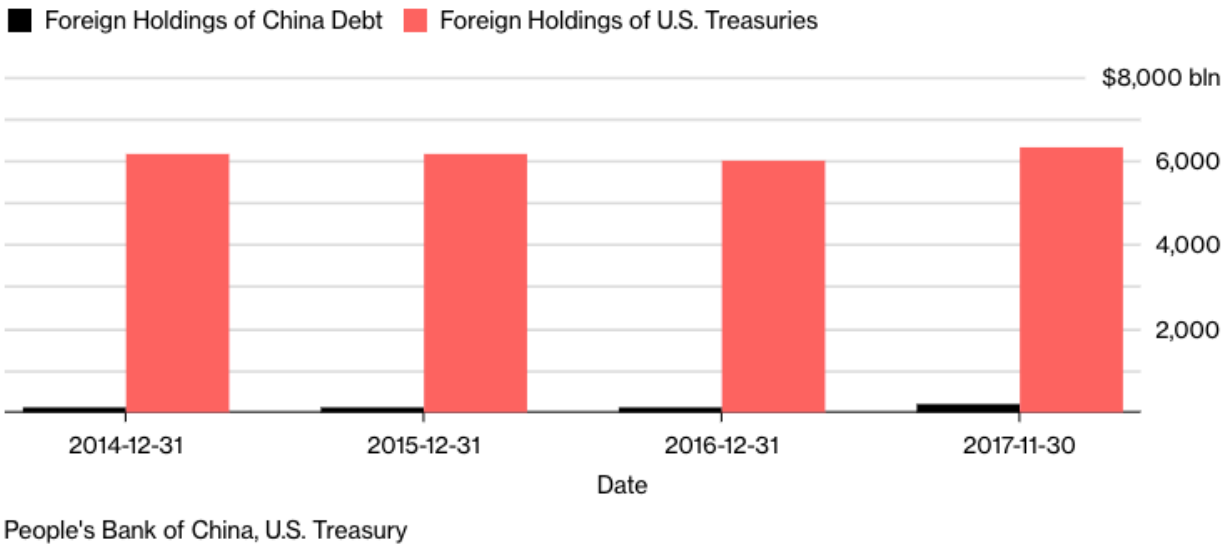


Source: Wind, BOCHK Asset Management Ltd., as of September 15, 2017.

“Market perception is that local agencies do not rate bonds to the same standards as international agencies,” says Scott Harman, Managing Director, Fixed Income & Multi Assets, FTSE Russell. “Local Chinese agencies are perceived to place greater emphasis on the implicit government support on state-owned companies. You see this also reflected in pricing, with yields on locally-AAA-rated corporates only 100-200 bps above CGBs. There is an expectation amongst investors that, in the event of a default, many companies can rely on governmental support, given their systematic importance to the Chinese economy” (FTSE Russell 2017). Nonetheless, there is still a high demand for onshore bonds by foreign investors in the long run.

CONCLUSION

China, already has the world’s third-largest bond market, but continuing to open up will offer domestic companies an alternative source of capital than banks. It’ll also help firm up Chinese banks’ balance sheets and improve corporate governance amid scrutiny from foreign investors. China pulled 346 billion yuan (\$55 billion) of foreign funds into bonds in 2017, central bank data show. About one-third of the flows since the start of July came via the Bond Connect launched that month with Hong Kong, Bank of China (Hong Kong) Ltd. says. While the total inflow is a fraction of the \$337 billion of foreign net purchases of U.S. Treasuries for 2017 through November, it marks a 41 percent surge from 2016. The acceleration will pick up this year, to 700 billion yuan, Deutsche Bank AG predicts (Deutsche Bank 2016). Foreigners still hold less than 2 percent of China’s domestic debt, according to data compiled by Bloomberg. The chart below provides the most recent comparison of foreign holdings of China’s debt when compared to the U.S. and just from first glance you can tell it is extremely smaller leaving a lot of potential for growth (Dai 2018).



While trading data for the link isn't available, total foreign flows into China's bond market last month were 42.9 billion yuan (\$6.8 billion) compared with 38.7 billion yuan in June. Foreign investment in the Chinese onshore bond market is tipped to triple over the next three years as Beijing continues to reduce barriers to its bond market (Robertson 2018).

Despite the potential for new policy announcements at China's 19th Party Congress in October, the People's Bank of China (PBOC) is expected to continue its attempts to simultaneously balance competing goals: controlling excess leverage in the economy by clamping down on excessive lending, while also trying to prevent an economic slowdown. According to 60 percent of economists in a Bloomberg survey conducted in August, the PBOC's broad policy stance will remain unchanged through the end of the year (FTSE Russell 2017). For the world economy, Chinese borrowers loom as a new source of competition for investors' money should its bond market keep opening. Overall having an effective bond market provides numerous benefits to any country and especially to one like China. Not only does having a public bond market have the economy rely less on banks, but it also allows for more information to be disseminated easily so that more systems in the country can be financed. With all the new

liberalization policies, China is fulfilling its potential to grow its infrastructure, economy, and be more connected to the rest of the world.

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